

INTERNAL REVENUE SERVICE

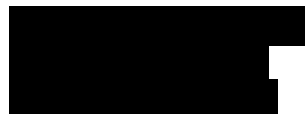
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Dear [REDACTED]:

Congressman Bob Ethridge asked us to reply to your letter to him dated April 17, 2001, concerning your objection to include a state income tax refund in calculating the taxable amount of social security benefits and the amount of deductible medical expenses. In your letter, you believe that retirees must include refunds in these calculations under tax forms and instructions that misinterpret the law.

We looked at the tax laws, forms and instructions underlying your concerns. The tax instructions and forms in question do not misinterpret the laws you mention. You also said that if the instructions and forms are correct, then the income tax laws are unfair. To help you understand these laws, I explain some of these tax rules below.

As a general rule, retirees' social security benefits are not subject to federal income tax if those benefits are their only source of income. We use a formula to determine if any social security benefits are taxed (Section 86 of Internal Revenue Code). The Social Security Benefits Worksheet in the Form 1040 instructions shows this formula. The effect of the formula is that a portion of a taxpayer's social security benefits may be subject to income tax. You sent a copy of this worksheet with your letter to Congressman Ethridge.

Under the worksheet, retirees must report on line 3 of the worksheet the same amount of state income tax refund that they report on line 10 of the Form 1040. Retirees do not report any of the tax refund on line 10, if in the year they pay the tax, they did not itemize deductions. If retirees do not itemize, they will not report their refund on line 3 of the worksheet. If retirees itemize deductions, then they use the State and Local Income Tax Refund Worksheet on line 10 in the Form 1040 instructions to find out if the refund is taxable. They include taxable amount on line 10 and line 3. Whether retirees have to report state tax refund on these lines depends on their personal situation.

You are right the worksheet does not consider retirees' Schedule A Itemized Deductions for state income taxes, but it does account for a refund of these deductions

on line 10. This happens because many years ago the Congress introduced into the tax law the technical concepts of “adjusted gross income,” “itemized deductions,” and “standard deduction” to simplify tax administration and compliance. The Congress decided adjusted gross income is calculated by deducting from gross income only certain amounts commonly known as “above the line deductions.” “Below the line deductions” are deductions subtracted from adjusted gross income to determine taxable income. The deduction for state income taxes is an example of an itemized below the line deduction.” As stated, for income tax purposes, tax law does not account for itemized “below the line deductions” in computing taxable social security benefits.

You also said it is unfair that retirees who report a state income tax refund on line 10 of the Form 1040 may lose some of their medical expense deduction under Schedule A. This happens in some situations; however, the income tax law is clear. A taxpayer who wants to take a medical expense deduction under Schedule A may deduct only the expense that exceeds 7.5% of the amount of adjusted gross income shown on line 34 of Form 1040. A state tax refund on line 10 is one of many income items added in adjusted gross income that can affect a retiree’s medical expense deduction.

Also, taxpayers may take an itemized deduction for state income taxes when they are in a low tax bracket. Taxpayers may be in a higher tax bracket if they later receive a refund of that tax. You believe this is unfair because these taxpayers must pay federal income tax on the refund at a rate higher than the rate for which they took the deduction. We agree this situation happens, but these taxpayers can also benefit if the opposite occurs. For example, they could be in a lower tax bracket at the time they receive the refund and pay tax at a lower rate. The tax law attempts to treat taxpayers equally as their income shifts up or down.

Thank you for taking the time to express your concerns. I hope this information is helpful. Please call Elliot M. Rogers, identification number 50-11827, at (202) 622-4920, if you have any questions.

Sincerely,

Michael A. Swim
Chief, Employment Tax Branch 1
Office of the Associate Chief Counsel
(Tax Exempt and Government Entities)